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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the	)	CC Docket No. 96-128
Pay Telephone Reclassification	)	
and Compensation Provisions of the	)	DA 97-1673 (Remand)
Telecommunications Act of 1996	)	
	)	

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COMMENTS OF THE
COMPETITION POLICY INSTITUTE

ON REMAND ISSUES
IN THE PAYPHONE PROCEEDING

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Comments of the Competition Policy Institute
on Remand Issues in the Payphone Proceeding
CC Docket No. 96-128

I. Introduction

The Competition Policy Institute (CPI) respectfully submits these Comments in response to the Commission's Public Notice DA 97-1673 concerning the matters raised in the D.C. Circuit Court of Appeal's remand of certain portions of the Commission's *Payphone Orders.*[1] CPI is an independent non-profit organization that advocates policies to bring competition to energy and telecommunications markets in ways that benefit consumers. CPI appreciates the opportunity to comment on these matters because of the significant issues raised for competition in the payphone industry and because of the substantial effect these orders will have on the rates paid by consumers.

II. The Commission Should Modify the Default Compensation Rate

The Court remanded the portion of the Commission's decision in which the "default" rate for compensation for subscriber 800 calls and access code calls was set at 35 cents per call, the same rate as the maximum rate for local coin calls during the second year of the interim period. The Commission seeks comments on whether there are cost differences between local coin service and subscriber 800 calls and access code calls. The Commission also seeks comments on whether and how any cost differences should affect a market-based compensation amount.

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[1]*Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No 96-128. The Report and Order ("*Payphone Order*") and Order on Reconsideration ("*Order on Reconsideration*") are referred to as "*Payphone Orders.*"

Finally, the Commission seeks comments on whether the local coin rate, adjusted for cost differences, is an appropriate default rate to use for compensation to payphone service providers (PSPs).

CPI agrees with the Court that the *Payphone Orders* do not justify setting the default rate of compensation for subscriber 800 calls and access code calls equal to the local coin rate of 35 cents. This portion of the decision should be reviewed and modified by the Commission . This issue is a significant one for consumers, especially for traveling consumers using calling cards and customers that use "debit" cards for long distance calling. A charge of 35 cents per call becomes a significant fraction of the total cost of a long distance call made from a payphone using a credit card or a debit card. In recent months, in response to the Commission's decision, the large IXCs raised their credit card rates by 35 cents, passing through to consumers the increase prescribed by the Commission. Similarly, the addition of a 35 cent charge to each 800 number made from a payphone is likely to cause a diminution of value of these "toll free" numbers both for consumers and for the purchasers of 800 number services.

The Commission arrived at its original decision on this issue through the following syllogism: the market price of local coin phone calls is 35 cents; subscriber 800 calls and access code calls are similar to local coin phone calls; therefore the default rate for these calls should also be 35 cents. This syllogism fails on two counts: first, 35 cents likely overstates the competitive price for local coin phone calls; and second, subscriber 800 calls and access code calls are not similar to local coin calls. We examine each aspect of this syllogism.

The Commission concluded that 35 cents is the market price of local coin service on the basis of coin rates in five states that deregulated coin phone service. But the Commission errs in assuming that sufficient competition exists in the payphone business to conclude, on such scant evidence, that 35 cents is a market-based rate for payphone charges. To be exact, 35 cents is the predominant *deregulated* price for a local call from a payphone. There is no reason to believe that 35 cents is also the price that a competitive payphone industry would provide. The Commission could just as easily have concluded that 35 cents represents an accurate estimate of the *monopoly* price for local coin calls.

CPI does not disagree with the Commission's basic premise that a competitive market is superior to regulatory scrutiny and cost studies when determining a competitive price for coin phone service. The difficulty here is that a competitive payphone market is nowhere in sight. The payphone industry in 1997 is far from competitive; deregulating payphone service is not likely to make the industry competitive any time soon. The ability of location owners and payphone providers to exercise market power, the lack of consumer understanding of the industry, and the perverse incentives provided to PSPs all conspire to keep prices above competitive levels. To the extent that there is competition at all, it is competition among PSPs for locations, not between PSPs seeking to provide the lowest price for consumers.

The market for locations and the market for consumers are different and must be viewed as distinct by the Commission. The OSP "scandals" which began in the late 1980's (with which state commissions and the FCC are so familiar) teaches that a competitive market for consumer services does not yet exist. The ability of some OSPs to extract outrageous sums from consumers was due in equal parts to the existence of locational monopolies and the practice of blocking access to alternative long distance carriers. The situation was compounded by a very poor consumer understanding of the new industry. The Commission and the Congress may have corrected the issue of access to long distance carriers, but they cannot correct the locational monopoly aspect of the payphone business.

In its *Payphone Orders,* the Commission frequently acknowledges that the market for payphones is not competitive, while proceeding to deregulate the industry and establish default compensation rates and coin phone rates based on deregulated prices in five states. In the case of the compensation rate, the Commission supports its decision to adopt 35 cents as the default rate in part on its belief that IXCs can block calls from payphones if the rate is "too high." The Commission reasons that this ability to block calls gives the IXCs leverage to negotiate with the PSPs to constrain the rate of such compensation. But consumers should take little comfort in this scenario.

Where PSPs are monopolies or near-monopolies—and CPI agrees with NASUCA that these occasions are numerous—the PSPs will be content to let the per-call rate approach a level that maximizes revenues, even if that means that some calls are blocked. But this is *precisely* the economics definition of a monopoly price. The ability of an IXC to block a call when the price is too high does not mean that the resulting price (just below the blocking threshold) will equal the price that a competitive market would deliver. It simply means that the PSP has been able to extract the maximum revenue from the interexchange carriers and the consumers they serve. This is not competition.

The second part of the Commission's syllogism is that subscriber 800 calls and access code calls are similar to local coin calls for purposes of determining the cost. In other words, the Commission uses the price of deregulated local coin calls as a surrogate for the competitive price for subscriber 800 calls and access code calls placed at payphones.

The record before the Commission contains much evidence that PSPs experience lower costs for subscriber 800 calls and access code calls, compared to the costs of completing local calls. This analysis is reasonable since PSPs do not incur the costs of visiting phone locations and collecting and handling coins for subscriber 800 calls and access code calls. The coin mechanism in a payphone is the source of much of the maintenance costs of these phones and is the avenue through which most of the vandalism will occur. Ultimately, a PSP does not even need to provide a coin phone for calls to an 800 number or for calls using a credit card or a debit card. All that is needed is a receiver, a keypad capable of originating dialing codes and some electronics to identify the phone to the network. In this respect, local coin calls have little in common with subscriber 800 calls and access code calls.

There are other differences as well. Some parties argue that the PSP's costs apply only to one end of subscriber 800 calls or access code calls which terminate in the networks of the interexchange carriers. In contrast, these parties argue, the PSP has the responsibility for terminating local coin phone calls into the local exchange network.

Another difference is related to the duration of the calls. We expect that a typical interexchange call is of shorter duration than a typical local call since the interexchange call is usually billed to the subscriber on the basis of minutes of use while a local call usually is not. When PSPs are charged for the public access line on a measured basis, this means that access code calls will cost the PSP less than the typical access code call. In some cases, the longer duration of local calls may mean that the PSP experiences an "opportunity cost", since fewer, longer local calls might displace a greater number of shorter long distance calls.

On the basis of all these differences, it is reasonable to conclude that the cost of subscriber 800 calls and access code calls are likely to be less for a PSP than the costs of a local coin call. CPI respectfully suggests that the Commission must review and revise its conclusion that 35 cents is the correct default rate to establish for subscriber 800 calls and access code calls.

In its Notice, the Commission inquires whether the differences between local coin call costs and the costs of subscriber 800 calls and access code calls could be used as the basis for reducing the 35 cent rate and arriving at a revised default compensation rate. While this approach can certainly be taken, CPI suggests this is the wrong way for the Commission to proceed. This tack will merely compound the error made by assuming that the 35 cent rate is the competitive price for local coin costs. Since this method assumes a basic similarity between coin calls and these other compensable calls which may not exist, it will not produce an accurate rate for compensating PSPs for subscriber 800 calls and access code calls. Instead of using this "top down" method based on the 35 cent rate, the Commission should adopt a "bottom up" approach to determine the correct level of compensation. In other words, it is appropriate for Commission to examine the costs of providing the service when setting this rate.

In this regard, we must disagree with the sentiment, expressed in the Commission's order and in the comments of some parties, that there is necessarily a gulf between competitive rates and cost-based rates. It is an axiom of economics that a competitive market will produce prices that are based on marginal *costs.* A competitive market will not countenance a producer that persistently charges more than the cost of producing a product. If such behavior is attempted, another competitor will enter the market and undercut the price, forcing the first producer to reduce the price or leave the market. In short, competition drives prices to cost. For that reason, there is nothing incorrect or retrograde about the Commission setting maximum rates for compensation to PSPs based on these providers' costs when market pressures are insufficient to achieve that result. Using cost as the basis for compensation for PSPs does not violate the Commission's commitment to use competitive forces to determine prices whenever possible. The distinction is with the process of getting to that price, not the price itself. After all, rate-of-return regulation arguably should be abandoned not because of its theory (that rates should equal costs) but because of its practice (the method provides incorrect or insufficient incentives).

The Commission's obligation under Section 276 of the Communications Act may include the requirement that it ensure fair compensation for payphone service providers and promote competition in the payphone business, but that does not mean that the Commission must disregard its overarching obligation to ensure that prices for telecommunications services are just and reasonable. It is possible to achieve both objectives. The Commission does not serve the public interest by permitting firms with market power to collect rates bearing no relation to the costs of providing a service in the name of promoting competition. This is akin to the notion from the Vietnam war of "burning down the village in order to save it."

Finally, CPI suggests that the Commission should require PSPs to refund any difference between 35 cents per call and a revised compensation rate for all charges made since the date of the remand from the Court of Appeals. The Commission should also seek a commitment from the IXCs to return this refund to their customers. Unfortunately for consumers, the Commission cannot "unring the bell" for those compensation charges, provided under contract, that have been influenced by the Commission's adoption of the 35 cent default rate.

III. In Response to the Court's Concerns, the Commission Should Provide Additional Justification and Re-adopt Its Requirement to Use the Commission's Affiliate Transaction Rules for LEC Coin Phone Assets Transferred to a Separate Affiliate.

The Court remanded those portions of the *Payphone Orders* in which the Commission applied its policies for affiliate transactions to the situation where a LEC's payphone assets are transferred to a separate subsidiary. The Commission's policy requires that the assets be transferred at book value or market value, whichever is higher. The Court reasoned that, because LECs have been regulated by the Commission under price cap regulation since 1990, the risk associated with payphone assets has resided with the LECs (and not with consumers) so that the shareholders of the LECs deserve the increase in capital valuation that has attached to the payphone assets. In making this finding, the Court referred to its decision in the *Democratic Central Committee* case and requires the Commission to apply the "two-step" analysis of that case.

CPI supports the Commission's original decision in this matter and believes that the Commission's original decision can be sustained even if the Commission is required by the Court to use the analysis of the *Democratic Central Committee* case. In reaching its decision, we believe that the Court relied on an imperfect understanding of how price caps function and incorrectly concluded that price caps had shifted risk from ratepayers to shareholders.

As a preliminary matter, we note that price cap regulation is designed to improve the incentives that are inherent in any form of economic regulation. Rate of return regulation is frequently criticized for the incentives it provides and price cap regulation was designed to correct that shortcoming. Price caps are not designed to shift risk between ratepayers and the regulated entity. Depending on the specific ingredients in the price cap plan, risk may or may not shift between consumers and producers. The facile claim that price cap regulation shifts the risk of the regulatory system from consumers to shareholders simply does not hold up on close examination.

Consider the following features and attributes of the actual practice of price caps for the large LECs that has been in place at the FCC since 1990:

- The FCC's price cap plan permits the LECs to exercise the right to raise prices if the calculated return on investment falls below 10.25%. This "low end adjustment" eliminates the possibility that LEC profits will fall to a level that could be said to cause impairment of their ability to recover their capital investment. In practice, this feature provides more nearly a "guaranteed return" than the rate of return regulation that price caps replaced.

- The Commission's price cap formula permits LECs to adjust their price cap indices for "exogenous" cost changes. In contrast to a firm in a competitive market, this adjustment ensures that a LEC has the ability to increase prices in response to cost changes beyond the LEC's control. This opportunity sharply guards against reductions in earnings that could limit the ability to earn a market return on capital.

- Under price caps, LECs are shielded from the effects of inflation by the price cap formula itself. The price cap formula allows adjustment in prices for cost changes (calculated as a productivity-adjusted inflation offset). Once again, this feature of price caps reduces significantly one of the risks faced by any business — the risk that higher prices for its inputs will outstrip the firm's ability to increase productivity.

- The initial prices used by the LECs to set their price caps were based on prices in effect at the changeover from rate of return regulation. This means that any excess earnings present at the time that price caps were instituted were captured in the initial price. In other words, prices were not "zero-based" at the inception of price cap regulation. Prices that were sufficient to provide (at least) an adequate return on capital were used as the starting point for prices under the new regime. The Commission did not revisit the prudence of the investments used to compute these rates or examine the market valuation of the assets at the outset of price caps.

- *In practice*, the FCC's price cap regulation formula shielded the LECs from the risk of capital loss by yielding consistently above-market returns for the LECs. This occurred because the formula's X-factor was set too low. In its recent *Price Cap Order*, the Commission determined that the correct X-factor for the LECs is 6.5%. This represents an increase over the 3.5% X-factor adopted in 1990 and the range of X-factors available to the LECs following the performance review of the operation of price caps. Since 1990, owing in large part to the low X-factor, LECs have earned returns in excess of their cost of capital on assets.

The combination of these considerations leads to the conclusion that the LECs were well shielded against the potential of the loss of their assets while being regulated under price caps since 1990. It simply cannot be said that the change from rate of return regulation to price caps significantly altered the risks to the LECs, either in theory or in practice. For that reason, CPI believes the Commission should determine, after following the Court's requirement that the Commission use the principles of *Democratic Central Committee*, that it is appropriate for consumers of the LECs to retain the increased value of the assets used in providing payphone services when those assets are transferred to a separate subsidiary.

IV. Conclusion

CPI appreciates the opportunity to present these comments on some of the issues raised in the Court's remand of the Commission's *Payphone Orders*. We respectfully request that the Commission modify its orders as recommended in this response to its Public Notice.

Respectfully Submitted,

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